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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

O. D. HARRISON and wife JENNIE L. HARRISON; ADDISON O. WOOD and wife JOANNA G. WOOD; and EDWARD H. JACKSON and wife MARGARET J. JACKSON,
Petitioners,

versus

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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Shreveport, Louisiana, December 18, 1962.

LECOMTE, SHREVEPORT, LOUISIANA

TABLE OF CONTENTS

	Page
OPINIONS BELOW	2
JURISDICTION	2
QUESTION PRESENTED	2
STATUTES INVOLVED	3
STATEMENT OF THE CASE	4
SUMMARY OF ARGUMENT	6
ARGUMENT	9
I. The Decisions of the Circuit Courts of Appeals are Conflicting.	9
II. The Statute in Issue Clearly Provides that Gain from Amounts Received in Retirement of Registered Corporate Bonds is Capital Gain.	11
III. The Legislative History of the Statute Unqualifiedly Corroborates the Views Expressed in the Case of Commissioner vs. Caulkins, 144 F. 2d 482. (C.A. 6, 1944)	15
IV. Contemporaneous Judicial Construction is in Accord with the Caulkins Case.	17
V. Contemporaneous Administrative and Legislative Construction is in Accord with the Caulkins Case.	21
VI. Conclusion	25

APPENDIX

OPINION OF THE COURT OF APPEALS 1

CONCURRING OPINION 6

JUDGMENT 9

DECISION ON REHEARING 11

OPINION OF DISTRICT COURT 12

TABLE OF AUTHORITIES

Statutes	Page
Revenue Acts,	
1934, Section 117(d)	17
Section 117(f)	8, 15, 17
1936, Section 117(f)	22
1938, Section 117(f)	22
Internal Revenue Code of 1939, Section 117(f)	3, 6, 7, 10, 16, 22
Internal Revenue Code of 1954, Section 1232(a)(1)	3, 7, 10, 23, 27
Section 1232(a)(2)	27

Cases	
Adolph Klein, 15 T.C. 26 (1950)	15
Commissioner V. Caulkins, 144 F. 2d 482 (C.C.A. 6th, 1944)	7, 9, 12, 15, 23
Commissioner v. Morgan, 272 F. 2d 936 (C.A. 9th, 1959)	10, 16, 25, 27
Driscoll v. Commissioner, 306 F. 2d 35 (C.A. 7th, 1962)	21
Eli D. Goodstein, 30 T.C. 1178 (1958), affd., 267 F. 2d 127 (C.A. 1st, 1959)	15
Fairbanks v. U. S., 306 U.S. 436, 59 S.Ct. 607, 83 L. Ed. 855 (1939)	8, 9, 18, 25
Hanover Bank v. Commissioner, 369 U.S. 672, 82 S.Ct. 1080 S.Ct. 1080, 8 L. Ed. 2d 187 (1962)	7, 11
Howard C. Avery, 13 T.C. 351 (1949)	15

Lurie v. Commissioner, 156 F. 2d 436 (C.A. 9th 1946) 10, 23

McClain v. Commissioner, 311 U.S. 527, 61 S.Ct. 373, 85 L. Ed. 319 (1941) 8, 9, 19, 21, 25

Rieger v. Commissioner, 139 F. 2d 618 (C.A. 6th, 1943) 10,23

Rosen v. U.S. 288 F. 2d 658 (C.A. 3rd, 1961) 10, 11

Steven W. Kormendy, 18 T.C.M. 353 (1959) 15

Timkin, 6 T.C. 483 (1946) 15

U.S. v. Fairbanks, 95 F.2d 794 (C.A. 9th, 1938) 17

Administrative Regulations and Rulings

Regulations, I.R.C. 1954, Sec. 1.1232(a)-2 TD 6253, 1957-2 C.B. 556 24

I.T. 2846, XIV - 1 C.B. 112 (1935) 22

Acquiescence Noted, C.I.R. v. Caulkins, 1944 C.B. 5 26

Rev. Ruling 56-299, 1956-1 C.B. 603 26

Reports of Congressional Committee

House Committee on Ways and Means on Revenue Act of 1934, 1939-1 C.B. (Part 2) 577 ..... 16, 26

House Committee on Ways and Means on I.R.C. of 1954, 1954 U.S. Code, Congressional and and Administrative News, Vol. 3, p. 4110 (1954) 23

Miscellaneous

Janin, The Israeli Bond Ruling: Legislation by Administrative Fiat? 33 Taxes (March 1955) 191 (1955) 25

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Petitioners, O. D. HARRISON and JENNIE L. HARRISON (husband and wife), ADDISON O. WOOD and JOANNA G. WOOD (husband and wife) and EDWARD H. JACKSON and MARGARET J. JACKSON (husband and wife) respectfully pray that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Fifth Circuit entered June 22, 1962, and made final by denial of a petition for rehearing on September 27, 1962, reversing a decision of the United States District Court for the Western District of Louisiana.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 304 F.2d 835 (C.A. 5th 1962) and is reproduced at Page 1 of the Appendix hereof. It also appears at Page 121 of the Transcript. The decision of the District Court is not reported, but is found at Page 66 of the Transcript.(1) This opinion has also been reproduced at Page 12 of the Appendix hereof.

JURISDICTION

The judgment of the Court of Appeals *(Tr. p. 129, App. p. 9)* was entered June 22, 1962. Application for rehearing was timely filed by petitioners *(Tr. p. 130)*, and on September 27, 1962 an order was entered denying the petition for rehearing *(Tr. p. 145, App. p. 11)*, thus making final the judgment of the Court of Appeals. Jurisdiction is conferred upon this Court by 28 U.S.C.A. Section 1254 (1).

QUESTION PRESENTED

The question presented for decision in this case is whether for the purpose of the Federal income tax, and under the terms of Sections 117(f) I.R.C. 1939 and 1232(a)(1) I.R.C. 1954, petitioners are entitled to treat the gain from amounts received by them in retirement of corporate

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(1) It also appears at the same page of the Record of the proceedings before the Court of Appeals, nine copies of which are filed with this application. Pages 1 through 119 of the Transcript and Pages 1 through 119 of the Record are identical.

bonds issued in registered form and purchased for less than their face amount as gain from the sale or exchange of capital assets, or whether the difference between the cost of such bonds to them and the amount received upon retirement of the bonds constitutes ordinary income.

Although the question is simple, it has given rise, within the past few years, to considerable litigation in the various circuits and in the Tax Court with conflicting decisions hereinafter discussed.(2)

STATUTES INVOLVED

The question presented requires an interpretation of I.R.C. 1939 Section 117(f) and I.R.C. 1954 Section 1232(a)(1), which provide as follows:

"117. Capital gains and losses

"(f) Retirement of bonds, etc. For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

"1232. Bonds and other evidences of indebtedness

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(2) In addition to the reported cases, involving the question, which are discussed in the argument below, petitioners believe that the following cases presently pending upon the docket of the Tax Court involve substantially similar issues: **Raymond F. and Kathryn Cushing,** Docket No. 1363-62; **Thomas E. Wood,** Docket No. 3014-62.

"(a) General Rule. — For purposes of this subtitle, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof —

"(1) Retirement. — Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954)."

STATEMENT OF THE CASE

This action involves three consolidated suits filed by each husband and wife party hereto for the recovery of Federal income taxes erroneously assessed and paid by them for the years 1953 through 1957.[3] The facts are uncontradicted, were completely stipulated in the trial court and can be summarized as follows:

The Washington Youree Hotel Company (hereinafter simply referred to as the "Hotel Company") operates the Washington Youree Hotel in Shreveport, Louisiana *(Tr. p. 36)*. On April 29, 1952, petitioners purchased (in varying amounts) from the Hotel Company sixty (60) serially numbered, non-interest bearing bonds in regis-

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(3) The year 1954 is not involved in the case of petitioners Addison O. Wood and his wife.

tered form having a face amount of $404,850 *(Tr. pp. 36, 57)*. The purchase price was $300,000 cash *(Tr. p. 37)*. The bonds, although non-negotiable, were fully transferrable and were secured by a second mortgage on the Hotel Company property with The First National Bank of Shreveport serving as Trustee under the mortgage *(Tr. pp. 36, 59)*. Petitioners had no other interests in the Hotel Company *(Tr. p. 38)*. The bonds were registered with the Trustee and were held by petitioners until maturity *(Tr. p. 38:* The bonds maturing during the years 1952 through 1956 were duly paid and retired by the Hotel Company *(Tr. p. 38)*. Those maturing in 1957 were not retired in full, a partial retirement being made of them with an extension agreed to for the payment of the balance *(Tr. p. 38)*.

In their returns for the years 1953 through 1957, petitioners reported the difference between the cost of the bonds and the amounts received upon their retirement as amounts received from the sale or exchange of capital assets and included the gain from the transaction in their returns as long-term capital gain. The Commissioner of Internal Revenue determined that the difference between the cost of bonds to petitioners and the amount received upon the retirement of the bonds constituted ordinary income and assessed a deficiency which was paid. Claims for refund were timely filed by petitioners and rejected by the Commissioner *(Tr. pp. 19, 22, 26)*. These suits for refund were then timely filed against the United States

in the United States District Court for the Western District of Louisiana *(Tr. pp. 2, 7, 12)*.(4)

The cases were consolidated for all purposes by the District Court *(Tr. p. 33)*. The District Court held that the amounts received upon retirement of the bonds constituted amounts received upon retirement of bonds in registered form within the meaning of Section 117(f) I.R.C. 1939 (as to the year 1953) and within the meaning of Section 1232(a)(1) I.R.C. 1954 (as to the later years) and that, accordingly, the gain upon the transaction constituted long-term capital gain (App. p. 12)

Upon appeal by the Government, the Fifth Circuit Court of Appeals reversed the lower court's decision and held that the transaction was not within the intendment of the sections in question and that the gain from the transaction constituted ordinary income to petitioners. It is the review of this decision that is here sought.

There is no dispute as to the amount involved, the parties having agreed that if petitioners are correct in their contentions the judgment rendered in the lower court is correct *(Tr. pp. 62, 64)*.

SUMMARY OF ARGUMENT

I. The question presented is whether the difference between the face amount received upon their retirement and the cost of registered corporate bonds issued at a discount comes within the purview of Sections 117

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(4) Petitioners were, at all times relevant hereto, residents of Shreveport, Louisiana, in the Western District of Louisiana.

(f) I.R.C. 1939 and 1232(a)(1) I.R.C. 1954, both of which provide in part: "amounts received by the holder upon the retirement of bonds . . . in registered form shall be considered as amounts received in exchange therefor." There is a clear conflict between the decision of the court below and that of the Sixth Circuit in *Commissioner v. Caulkins*, 144 F. 2d 482 (C.A. 6th, 1944). The court below held that although the gain in question came within the literal terms of the act, it did not come within its intention and the gain from the transaction not being capital in nature was ordinary income. The Sixth Circuit in the *Caulkins* case held that the provisions of the law were clear, that the amounts in question fell within the terms of the act and that the gain was gain from the exchange of a capital asset.

II. This Court has held in a number of cases, including a very recent one, *Hanover Bank v. Commissioner*, 369 U.S. 672, 82 S. Ct. 1080, 8 L.Ed. 2d 187 (1962), that the words of statutes including the revenue acts should be interpreted in their ordinary, everyday senses and that where the statute is clear resort should not be had to supposed Congressional intention to effect a purpose which does not appear from a fair reading of the language of the act. The ordinary sense of the statute involved is to treat the amount paid upon retirement of a bond as gain from the sale or exchange of the bond. The Sixth Circuit in the *Caulkins* case, after reviewing the history of the act, arrived at precisely the same conclusion using the principles set forth in the *Hanover Bank* case. The *Caulkins* decision is completely in accord with the juris-

prudence from the date of the adoption of Section 117 (f) in the Revenue Act of 1934 until the year 1959.

III. The legislative history of the statute clearly shows that Section 117 (f) was enacted to convert what had formerly been considered as payment of a debt to a capital transaction.

IV. This Court in the case of *Fairbanks v. U. S.*, 306 U.S. 436, 59 S. Ct. 607, 83 L. Ed. 855 (1939), agreed with the Ninth Circuit when, in referring to Section 117 (f) as it appeared in the Revenue Act of 1934, it stated: "When Congress determined as it did in 1934 to treat as capital gains, gains resulting from the retirement of bonds issued by a government or corporation, it had no difficulty in expressing its intent in clear and unambiguous language." This Court in *McClain v. Commissioner*, 311 U.S. 527, 61 S. Ct. 373, 85 L. Ed 319 (1941), found this to be the purpose of Section 117 (f) and asserted that if there were any inadequacies or inconsistencies in this, it was the function of Congress to change them, not the Courts'.

V. The Treasury Department apparently considered Section 117 (f) clear since no regulations were issued interpreting it, and in 1935, shortly after the adoption of the Revenue Act of 1934, the Commissioner ruled that the act clearly made the retirement of bonds a capital transaction even though the transaction might not be in fact capital by its nature and even though as to the issuer of the bonds it remained a debt transaction. Section 117 (f) was re-enacted several times while this ruling was in effect.

VI. Although the Internal Revenue Code of 1954 in Section 1232 (a)(1) changed prospectively an interpretation of Section 117(f) by a circuit court dealing with the question of whether the bonds had to be initially issued in registered form, it continued and re-enacted the balance of the section interpreted by the *Caulkins* case as extending capital gains treatment to a situation such as that involved in this case.

VII. Accordingly, the opinion of the court below is contrary to the *Caulkins* case, and to the opinions of this Court and is unsupported either by the plain language of the act, its legislative history or its administrative construction.

ARGUMENT

I. The Decisions of the Circuit Courts of Appeals are Conflicting.

The decision of the Court of Appeals is incorrect and is in direct and irreconcilable conflict with the decision of the Court of Appeals for the Sixth Circuit in the case of *Commissioner v. Caulkins*, 144 F.2d 482 (C.A. 6th 1944). It is also contrary to the interpretation given to the statute involved by this Court in the cases of *Fairbanks v. U. S.*, 306 U.S. 436, 59 S. Ct. 607, 83 L. Ed. 855 (1939) and *McClain v. C.I.R.*, 311 U.S. 527, 61 S. Ct. 373, 85 L. Ed. 319 (1941).

Prior to the instant case, the question at issue was considered by three separate Circuit Courts of Appeals, the Sixth Circuit in *Commissioner v. Caulkins*, 144 F.2d

482 (1944) and *Rieger v. C.I.R.*, 139 F.2d 618 (1943); the Ninth Circuit in *Commissioner v. Morgan*, 272 F.2d 936 (1959) and *Lurie v. C.I.R.*, 156 F. 2d 436 (1946), and the Third Circuit in *Rosen v. United States*, 288 F.2d 658 (1961). The Sixth Circuit held that under the plain language of the statute the holder of the bonds was entitled to report the gain as capital gain. The Ninth Circuit in *Lurie* held the gain from such a transaction was capital gain even though the bonds were not registered until shortly before they were retired. In *Commissioner v. Morgan*, supra, the Ninth Circuit held the gain to be ordinary income—without mentioning its prior decision in *Lurie*. The Third Circuit followed the *Morgan* case in *Rosen v. United States*, supra. The court below rejected the *Caulkins* case and followed that of *Morgan* and *Rosen* without mentioning either *Rieger* or *Lurie*. In its opinion, the Fifth Circuit summarized the matter as follows:

> "They [petitioners] rely on Section 117 (f) of the Internal Revenue Code of 1939 and Section 1232 (a) of the 1954 Code which provide that amounts received by the holder upon the retirement of bonds shall be considered as 'amounts received in exchange therefor.' The Government asserts that this provision does not *require* capital gains treatment of amounts received on the redemption of bonds but merely permits it; that the gain received by the taxpayers is in the nature of accrued interest on the capital invested and is taxable as regular income. Courts of Appeals in three circuits have ruled on this question. *Commissioner v. Caulkins*, 6 Cir., 1944, 144 F.2d 482 held that the statute compelled capitals gains treatment of the amounts received on

> the redemption of a bond. *Commissioner v. Morgan*, 9 Cir., 1959, 272 F.2d 936 and *Rosen v. United States*, 3 Cir., 1961, 288 F.2d 658 rejected the result reached in Caulkins, held that capital gains taxation is not compulsory under the statute, and imposed regular income taxes on the gains in question. . . . . We agree with the Morgan and Rosen interpretation and hold that the portion of the taxpayers' receipts representing the original issue discount must be taxed as regular income." [App. pp. 2 (Footnotes omitted)]

Implicit in the opinion of the Court is the fact that under the ordinary language of the acts the amounts received by petitioners would constitute amounts received in exchange for the bonds.[5] Notwithstanding this, however, the Court held: "In the light of its historical setting and pertinent tax principles, the natural reading of 'in exchange therefor' *is to permit* capital gains treatment, *not compel it.*"[6] (Emphasis supplied.) The Court then concluded in the instant case the gain must be taxed as ordinary income.

II. The Statute in Issue Clearly Provides that Gain from Amounts Received in Retirement of Registered Corporate Bonds is Capital Gain.

In the very recent case of *Hanover Bank v. Commissioner*, 369 U.S. 672, 82 S.Ct. 1080, 8 L. Ed 2d 187 (1962), this Court, in a case dealing with the amortization of bond premiums and in replying to an argument

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(5) It seems fair to state that this is also true of the opinions in Morgan and Rosen.

(6) App. p. 5.

by the Government which bears great similarity to that accepted by the Court of Appeals in this case, held:

> "A firmly established principle of statutory interpretation is that 'the words of statutes — including revenue acts — should be interpreted where possible in their ordinary, everyday senses.' Crane v. Commissioner, 331 US 1, 6, 91 L ed 1301, 1306, 67 S Ct 1047. The statute in issue here, in plain ordinary language, evidences a clear congressional intent to allow amortization with reference to any call date named in the indenture. Under such circumstances we are not at liberty, notwithstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of the statute."

What is the "ordinary sense of the statute involved"? When a bond is issued and is retired at maturity, what other amount could be received in its retirement if it is not the face amount of the bond? This is what petitioners received; this is what they claimed they received upon retirement; this is what they contended should be used in computing the gain received from the exchange of the bonds.

The Sixth Circuit in the *Caulkins* case, which was rejected by the court below, used precisely the same reasoning in arriving at its decision, as will appear from the following:

> "The decisive question is whether the amount received by the taxpayer falls within § 117(f), which provides that amounts received by the holder upon

retirement of the securities named shall be considered as amounts received in exchange therefor. If it does, the decision of the Tax Court is correct. As pointed out in Fairbanks v. United States, 306 U.S. 436, 59 S.Ct. 607, 83 L.Ed. 855, a case involving a profit received on the redemption of corporate bonds prior to the enactment of § 117(f) in 1934, the redemption before maturity of corporate bonds is not a sale and exchange of capital assets within the commonly accepted meaning of the words. The gain realized prior to 1934, the court held, was not a capial gain. Similarily, prior to 1934 losses on bonds were deducted in full, under the bad debt provisions of the statutes. Lebanon National Bank v. Commissioner, 3 Cir., 76 F.2d 792; Pacific National Bank v. Commissioner, 9 Cir., 91 F.2d 103. The Revenue Act of 1934 made a radical change in the prior law when it provided § 117(f) that amounts received on retirement of the securities listed should be calculated as capital gain or capital loss. Fairbanks v. United States, supra.

* * *

"While granting that the security held by the taxpayer is an evidence of indebtedness of the character described in §117(f), the Commissioner contends that that section was not intended to cover the gain from interest, but only capital gain. * * * The Commissioner hence urges that the increment in value of the certificate constitutes compensation for the use of the taxpayer's money, which the Supreme Court has recently stated to be interest, Cf. Deputy v. DuPont, 308 U.S. 488, 60 S.Ct. 363, 84 L.Ed. 416, and that as such it must be taxed in its entirety as ordinary income under §22(a).

"Congress might well have made the differentiation urged by the Commissioner, since it is difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income. The fact that the contract does not provide for equal amounts of interest to be set aside each year, available to the holder, does not affect the question. The increment is consideration paid for the use of the amounts paid in. Unfortunately for the Commissioner's contention, Congress has not made the differentiation.

"Where statutory standards are lacking, statutory language is to be read in its natural and common meaning.' Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 249, 61 S.Ct. 878, 85 L.Ed 1310; Kales v. Commissioner, 6 Cir., 101 F.2d 35. In the present case, the promise was to pay $20,000 at the expiration of the ten-year period. Clearly $20,000 was the amount received on the retirement of the certificate, and under the plain wording of § 117(f), it was taxable as a capital gain. A provision that the increment in such cases should be taxable under § 22(a) might or might not have been wise and fair; but Congress has not enacted it; and the courts cannot supply it by judicial legislation. Because of the application of the capital gains tax to securities which on their retirement may not result in capital gain, inconsistencies and inequalities may well result from the application of § 117(f). If this is so, the correction of this defect in the operation of the statute is for Congress and not for the courts. McClain v. Commissioner, 311 U.S. 527, 530, 61 S.Ct. 373, 85 L.Ed. 319. . . ."

This case is completely in accord with the jurisprudence interpreting Section 117 (f) from the date it was adopted in 1934 until the *Morgan* case was decided in 1959. See, in addition to the cases already cited:

Timkin v. C.I.R., 6 T.C. 483 (1946), (acq. noted 1946-2 C.B. 5);

Howard C. Avery, 13 T.C. 351 (1949) (acq. noted 1950-1 C.B. 1);

Adolph Klein, 15 T.C. 26 (1950) (acq. noted 1950-2 C.B. 3);

Steven W. Kormendy, 18 T.C.M. 353 (1959); and

Eli D. Goodstein, 30 T. C. 1178 (1958) (affirmed 267 F.2d 127 (1959)).[7]

III. The Legislative History of the Statute Unqualifiedly Corroborates the Views Expressed in the Case of Commissioner v. Caulkins, 144 F. 2d 482 (C.A. 6, 1944).

Although petitioners believe the law is clear and there is no necessity for resorting to its legislative history, an examination of this history and of the circumstances surrounding the adoption of Section 117 (f) completely affirms the Sixth Circuit's opinion.

As the *Caulkins* case indicated, the genesis of Section 117 (f) is found in a correspondingly numbered section of the Revenue Code of 1934. Prior to that time the retirement of a bond was not considered a sale or ex-

(7) Appeal by taxpayer on other points. The Court of Appeals did not pass upon the point in question because the Commissioner apparently did not urge it.

change but was simply treated as the payment of a debt. Any profit realized by the holder of the bond was *at that time* treated as ordinary income. Similarly, the loss suffered upon such a retirement was treated as a loss from a bad debt.

Section 117 (f) was enacted to change this. Although the legislative history of the provision is somewhat meager, it clearly demonstrates that the interpretation of the Sixth Circuit is correct. The House Committee reporting the bill simply stated:

> "Subsection (f) referring to Section 117(f) provides that amounts received upon the retirement of corporate bonds and similar evidences of indebtedness shall be considered as amounts received in exchange therefor."[8]

It appears that the provision was inserted partly at the insistence of a Committee of the American Bar Association. As noted by the Ninth Circuit in the *Morgan* case[9] the Committee urged Congress to extend capital gain and loss benefits to this type transaction. There is certainly no intimation in the history of the act that the section was intended to mean anything other than what is clearly states—that amounts received upon the retirement of a bond are considered to be as amounts received in exchange for it.

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(8). 1939-1 C.B. (Part 2), 577.

(9) At 272 F. 2d 936.

It also might be noted in passing that an exception to this general rule was inserted at the same time in Section 117 (d) of the Revenue Act of 1934 in dealing with losses from the sale or exchange of identical securities in the case of banks. This limitation clearly shows Congress, in enacting Section 117 (f), was aware of the fact that the basis of bonds of the type dealt with in that section might be more or less than the face amount thereof and specifically restricted or limited the applicability of such provisions in the case of banks. If any such limitation or qualification had been generally intended by Section 117 (f) surely Congress would have so provided.

IV. Contemporaneous Judicial Construction is in Accord with the Caulkins Case.

Shortly after the enactment of the Revenue Act of 1934, it was contended that Section 117 (f) was merely declaratory of the pre-existing law, and accordingly that gain of the nature involved in this case should, for years prior to 1934, be taxed at capital gain rates. In *U. S. v. Fairbanks*, 95 F.2d 794 (C.C.A. 9th 1938), the Ninth Circuit rejected this view, held that the addition of Section 117(f) was intended to radically change the law, and made the following comments pertaining to it:

> "The question now to be decided is whether the gain so realized by defendant was a 'capital gain.' . . .
>
> "We think not. Between the *redemption* of a bond and the *sale or exchange* thereof, there is a clear distinction. Such redemption is merely the payment of an obligation according to its terms. It is

in no wise a sale or exchange. Watson v. Commissioner, 27 B.T.A. 463, 465; Braun v. Commissioner, 29 B.T.A. 1161, 1177 . . .

". . . This doubtless, is the reason why prior to 1934 gains resulting from such redemption were never included in the definition of 'capital gain.' Whatever the reason, such gains were not so included, and the definition should not, we think, be expanded by judicial construction.

"*When Congress determined, as it did in 1934, to treat as 'capital gains' gains resulting from the retirement of bonds issued by a government or corporation, it had no difficulty in expressing its intent in clear and unambiguous language.* Revenue Act of 1934, § 117(f), 48 Stat. 715, 26 U.S.C.A. § 101(f). If such intent had existed prior to 1934, it could and, we think, would have found similar expression." (Emphasis supplied)

Certorari was granted by this Court[10] which approved not only the holding and interpretation of the law as made by the Circuit Court, but its construction of the Revenue Act of 1934. See *Fairbanks v. U. S.*, 306 U.S. 436, 59 S.Ct. 607, 83 L.Ed. 855 (1939).

Section 117 (f) also had the effect of converting what had formerly been considered a loss from a bad debt to a capital loss. Several cases were instituted by taxpayers who found their deductions for losses upon registered bonds limited by Section 117 (f). To resolve conflicting cases with respect to this matter, this Court grant-

(10) 305 U.S. 667, 59 S.Ct. 66, 83 L. Ed. 433 (1939).

ed certiorari in two of them.[11] In these cases, the taxpayers contended that Section 117 (f) was not "intended" by Congress to make the loss a capital loss. They argued a bond is "obviously" merely evidence of a debt. The failure of a debtor to pay his debt is "obviously" not a capital transaction. Accordingly, it was not "reasonable," they said, to conclude Congress would have "intended" to treat the loss from a bad debt as a capital transaction.

The Government on the other hand argued:

"The taxpayer's surrender of his bonds for cash constituted a retirement of the obligations within the meaning of § 117(f) 26 USCA Int. Rev. Acts, 1940 ed. p. 708, and the loss thereby sustained was a capital loss . . .

"*Section 117(f) covers all transactions whereby bonds or other evidence of indebtedness of a corporation or of a government are surrendered for cash and the debt is thereby extinguished . . .*" (Emphasis supplied) [12]

Mr. Justice Roberts delivered the opinion of this Court in which it agreed with the government for the following reasons:

"The earlier revenue acts contained sections similar to 23(k) of the Act of 1934. They also embodied provisions for calculation of taxes on capital net

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(11) **McClain v. C.I.R.**, 310 U.S. 620, 60 S.Ct. 1079, 84 L. Ed. 1393 (1939); **Helvering v. Thomson**, 310 U.S. 620, 60 S.Ct. 1079, 84 L. Ed 1393 (1939).

(12) Summaries of these arguments are found at 85 L. Ed. 319-320.

gains. None of them included any section like 117(f). Prior to the adoption of the 1934 Act it had been held that the phrase 'sale or exchange' of capital assets, employed in those Acts, was not descriptive of the redemption or call for repayment of corporate securities, and hence gain thereby occasioned was to be treated as ordinary income, and loss so arising was to be deducted from gross income as a bad debt.

"The Revenue Act of 1934, by subsection (f) of § 117, provided that for the purposes of the title dealing with capital gains and losses, 'amounts received by the holder upon the retirement' of such securities as are here involved, 'shall be considered as amounts received in exchange therefor.'

"It is plain that Congress intended by the new subsection (f) to take out of the bad debt provision certain transactions and to place them in the category of capital gains and losses.

* * * *

"The taxpayer in number 58 urges that to hold subsection (f) applicable in his case would give the provision an unjust effect, since, if he had refused to surrender his debentures for the trifling consideration offered, he could have charged off their whole cost as a bad debt under § 23 (k).

"*The answer is that we must apply the statute as we find it, leaving to Congress the correction of asserted inconsistencies and inequalities in its operation.*" (Emphasis supplied)

McClain v. C.I.R., 311 U.S. 527, 529, 61 S.Ct. 373, 85 L. Ed. 319, 322 (1941).

That this Court considered the enactment of Section 117 (f) to evidence a clear expression by Congress of its purpose to convert a transaction previously regarded as involving a debtor-creditor relationship to a capital transaction is clearly established.[13]

V. Contemporaneous Administrative and Legistive Construction is in Accord with the Caulkins Case.

Surely had Congress meant to restrict the provisions to losses suffered, it could have simply stated that losses from the redemption of bonds shall be treated as capital losses. Had it intended to exclude "original issue discount" from the gain provisions, it could have simply qualified the section by saying that amounts received from the retirement of bonds in excess of their issue price shall not be considered as being received in exchange for them. It did neither. The Treasury Department apparently found no such limitations inherent in Section 117 (f) either, since during the twenty years the section remained in effect no regulations were issued interpreting the section — indicating the section to be plain and unambiguous.

In spite of the Government's prese assertions as to Congress' intentions, the Commisssioner ruled, within

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(13) The **McClain** case was recently relied upon by the Seventh Circuit Court of Appeals in granting capital gain treatment to the retirement of evidences of indebtedness issued after January 1, 1955, under the provisions of Section 1232 (a) (1). The Court found the section to be clear and unambiguous. See **Driscoll v. C.I.R.**, 306 F. 2d 35 (C.A. 7, 1962).

a few months after the adoption of Section 117 (f), that capital gain was realized to the holder of bonds upon their retirement not because of the nature of the gain, *but because Section 117 (f) made it so* even though from the viewpoint of the obligor or issuer of the bonds it remained a debt transaction:

> "Under the Revenue Act of 1934, *it is clear as to the holder of bonds which are retired that the gain derived or loss sustained must be treated as a capital gain* or capital loss *in view of the provisions of section 117(f) of that Act,* which provides that amounts received by the holder upon the retirement of bonds shall be considered as amounts received in *exchange* therefor. *Such a gain or loss is a captial gain or capital loss, as the case may be, not by reason of the nature of the transaction itself but because of the specific provisions of section 117(f), supra.* However, the statute does not contain any such provision with respect to the transaction as viewed from the standpoint of the *obligor corporation.* There is no *sale or exchange* by the corporation in such a case as required by the statute in order for a transaction to result in a capital gain or a capital loss." (Emphasis partially supplied) I. T. 2846, XIV - 1 C.B. 112 (1935).

Congress re-enacted Section 117 (f) at least three times while this ruling was in effect.[14]

In 1953 when the Internal Revenue Code was under revision the House Committee which prepared the Revenue

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(14) See Section 117 (f) Revenue Acts of 1936, 1938, and I.R.C. 1939.

Act of 1954 inserted in their bill what is now Section 1232. In addition to the decisions of this Court just mentioned expressing its views as to the meaning of the act, there were at that time three Courts of Appeals cases directly construing the provisions of Section 117 (f)—the *Caulkins*, *Rieger* and *Lurie* cases, cited above. The *Caulkins* and *Rieger* cases held, as we have mentioned, that the difference between the cost and the face amounts of the certificates of indebtedness when received upon retirement constituted amounts received in exchange for the certificates. The *Lurie* case further held that this was true even though the bonds or certificates of indebtedness had only been registered shortly before they were retired. The Revenue Act of 1954 expressly changed the rule of the *Lurie* case in Section 1232 (a) (1) and left unchanged the rest of the provisions of 117 (f).[15]

In the Report of the House Committee which drew the Revenue Act of 1954, it is stated:[16]

"(E) Bonds and other debt (sec. 1232)

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(15) The change was accomplished by the parenthetical clause added to the end of Section 1232 (a) (1). Such a change would have been meaningless if the opinion of the court below were correct since the registration of the bonds would have had no effect in the Lurie case unless capital gains would result upon the retirement of registered (as distinguished from unregistered) bonds.

(16) Report of House Committee on Ways and Means on I.R.C. of 1954, 1954 U.S. Code, Congressional and Administrative News, Vol. 3, p. 4110 (1954).

"Under existing law any gain realized from a corporate or Government bond in registered form or with coupons attached is treated as a capital gain either if the bond is held to retirement or if it is sold or exchanged. Part or all of this gain, however, may represent discount on original issue which is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.

"Effective with respect to bonds issued after December 31, 1954, the committee bill provides that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income. This discount is apportioned over the entire period to the maturity of the bond and if the bond is sold prior to maturity only a pro rata portion of this discount is attributed to the gain realized by the seller. Any excess gain over the amount considered as ordinary income will be taxed as a capital gain. This rule is not applied to State and local government securities since interest income on these securities is free of tax. Rules for determining the original issue price are provided by the bill."

In the regulations issued by the Secretary of Treasury shortly after the 1954 Code was adopted, it was stated:

"Section 1232 (a) (1) provides that *any* amount received by the holder upon the retirement of an obligation shall be considered as an amount received in exchange therefor." [Regs. 1954, § 1.1232 (a)-2]

The history of the administrative interpretation of Section 117 (f) by the Commissioner of Internal Revenue

lends further support to the petitioners' position; however, rather than unduly lengthen this argument, petitioners refer the Court to an article by Mr. Harry Janin in the March 1955 issue of Commerce Clearing House's magazine "*Taxes*" at page 191, entitled "The Israeli Bond Ruling: Legislation by Administrative Fiat?" which completely discusses the matter.

VI. CONCLUSION

Until the *Morgan* case was decided, there was absolutely nothing in the jurisprudence, regulations or rulings which would indicate that there was any limitation upon the plain meaning of Section 117 (f). The Ninth Circuit in two cases prior to the *Morgan* case clearly thought that gains such as are involved in this case were made capital gains by Section 117 (f).[17] This Court in approving the *Fairbanks* case, and in the *McClain* case, considered the statute to do the same thing. The Commissioner of Internal Revenue in 1935, the year following the enactment of Section 117 (f), considered the law clear. The Treasury Department undoubtedly considered the law clear, or it would have issued regulations interpreting it. The Tax Court prior to the *Morgan* case thought the law was clear. The Sixth Circuit thought it was clear; and the Commissioner, until shortly before the 1954 act was

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(17) It is interesting to note that the Ninth Circuit in **Morgan** did not repudiate the **Fairbanks** case, and indeed, in effect, held that had the **Fairbanks** case arisen after Section 117 (f) was enacted capital gain would have occurred. See 272 F. 2d 938.

adopted, apparently was satisfied with the *Caulkins* case since he acquiesced in the decision in 1944 (1944 C.B. 5.) and this acquiescence continued until 1956 (Rev. Ruling 56-299, 1956-1 C.B. 603).

Furthermore, the taxation of the gain derived from the purchase of a bond at a discount and realized upon its retirement is entirely consistent with the purposes and intention of Congress in 1934 when the section was originally adopted. It is significant, we think, that in 1934 Congress was still grappling with the basic approach to be used in the taxation of capital gains and Section 117 of the Revenue Act of that year was a new and admittedly experimental approach to the problem. The basic premise upon which Section 117 was based was that income which is earned over a period of time but realized in one transaction should be taxed differently from income which ordinarily accrues annually or on a regular basis. Thus, the Committee said:

> "Subsection (a) provides for all taxpayers other than corporations a series of percentages which must be used in arriving at the amount of the recognized gain or loss which shall be taken into account in computing net income. The theory is that the gain or loss shall be somewhat reduced in proportion to the time for which the capital asset has been held."
>
> [1939-1 (part 2) C.B. 577]

The taxation of gain such as is here involved is entirely consistent with this since it cannot be realized until the bond is retired.

It is perhaps true that in recent years the philosophy underlying the taxation of capital gains has changed and Congress and the courts have adopted a more sophisticated approach to the subject in light of current economic thought. Thus, it appears fair to state that the length of time over which the income accrues is no longer the controlling factor in determining whether income should be taxed at capital gain rates, but it is whether the income essentially represents a conversion of capital. Whether, in light of this changing concept, gain from bonds purchased at a discount should be taxed at capital gain rates may be debatable and it may well have caused Congress to restate and *partially* restrict the applicability of the capital gain provisions to discount realized upon the retirement of bonds in Section 1232 (a) (2) with respect to bonds issued after 1954. Such a decision is the function of Congress. It is not the function of the Commissioner or the courts.

Petitioners submit that this case simply presents a situation wherein the court below and the Government has been unwilling to accept the fact that Congress, for reasons which it felt best, chose to treat as a capital transaction what the Commissioner now feels should be treated as a debtor-creditor relationship. The Government's entire argument, we believe, and the rationale of the *Morgan* case which was relied upon by the court below as controlling may be summarized simply in the statement that Section 117 (f) and its present counterpart, Section 1232 (a) (1), cannot mean what they say, because Congress could not have intended to do what it obviously did. This

argument has been properly answered in the *McClain* case and in the *Fairbanks* case by this Honorable Court and in the *Caulkins* case by the Sixth Circuit.

Petitioners respectfully submit that the opinion of the court below is incorrect and the writs of certiorari should be granted and thereafter that the decision of the Court of Appeals for the Fifth Circuit should be reversed.

Respectfully submitted,

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Attorney for Petitioners.

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Of Counsel

Shreveport, Louisiana
December 18, 1962.

CERTIFICATE

I, Leon O'Quin, attorney for the petitioners herein and a member of the Bar of the Supreme Court of the United States hereby certify that on the 18th day of December, 1962, I served copies of the foregoing petition for certiorari to the Supreme Court of the United States on the defendant, the United States, as follows:

1. By mailing a copy in a duly addressed envelope with air mail postage pre-paid to the Solicitor General, Department of Justice, Washington 25, D. C.;

2. By mailing a copy in a duly addressed envelope with postage pre-paid to Edward J. Shaheen, Esq., United States Attorney for the Western District of Louisiana, Federal Building, Shreveport, Louisiana; and

3. By mailing a copy in a duly addressed envelope with air mail postage pre-paid to Louis F. Oberdorfer, Esq., Assistant Attorney General, Department of Justice, Washington, D. C.

LEON O'QUIN,
Fifth Floor, First National Bank Building,
Shreveport, Louisiana,
Attorney for Petitioners.

IN THE

UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 19059

UNITED STATES OF AMERICA,

Appellant,

versus

O. D. HARRISON and wife JENNIE L. HARRISON; ADDISON O. WOOD and wife JOANNA G. WOOD; and EDWARD H. JACKSON and wife MARGARET J. JACKSON

Appellees.

Appeal from the United States District Court for the Western District of Louisiana.

(June 22, 1962)

Before RIVES, BROWN, and WISDOM, Circuit Judges.

WISDOM, Circuit Judge: This action for tax refunds presents the question whether amounts of original issue discount or interest received upon retirement of corporate bonds are taxable as capital gain or ordinary income.

In 1952 the taxpayers purchased original issue

discount bonds due to mature in series over the next five years. As the bonds were redeemed, the taxpayer reported their gain as long-term capital gain. They rely on Section 117 (f) of the Internal Revenue Code of 1939 and Section 1232 (a) of the 1954 Code which provide that amounts received by the holder upon the retirement of bonds shall be considered as "amounts received in exchange therefor." The Government asserts that this provision does not *require* capital gains treatment of amounts received on the redemption of bonds but merely permits it; that the gain received by the taxpayers is in the nature of accrued

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[1]Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

(f) *Retirement of Bonds, Etc.* For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * *

(26 U.S.C. 1952 ed., Sec. 117.)

Internal Revenue Code of 1954:
SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) *General Rule.* — For purposes of this sub-title, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof —

(1) *Retirement.* — Amounts received by the holder on retirement of such bonds or other evidence of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

* * * *

(26 U.S.C. 1958 ed., Sec. 1232.)"

interest on the capital invested and is taxable as regular income. Courts of Appeals in three circuits have ruled on this question. *Commissioner v. Caulkins*, 6 Cir.; 1944, 144 F. 2d 482 held that the statute compelled capital gains treatment of the amounts received on the redemption of a bond. *Commissioner v. Morgan*, 9 Cir., 1959, 272 F. 2d 936 and *Rosen v. United States*, 3 Cir., 1961, 288 F. 2d 658 rejected the result reached in Caulkins, held that capital gains taxation is not compulsory under the statute, and imposed regular income taxes on the gains in question. See also *Jaglom v. Commissioner*, 2 Cir., June 4, 1962, F. 2d, citing Morgan and Rosen with approval, and holding that the portion of the proceeds from the "flat" sale of defaulted bonds which is allocable to interest accrued while the tax-payers held the bonds is taxable as ordinary income. We agree with the Morgan and Rosen interpretation[2] and hold that the portion of the tax-payers' receipts representing the original issue discount must be taxed as regular income.

The facts of the case are not disputed. The taxpayers purchased second mortgage bonds with a face value of $404,850. They paid $300,000, leaving an original issue discount of $104,850, or 25.9 per cent of the face value. The discount represented a purchase bonus of $50,000 and interest at three and three-quarters per cent until maturity. The purchase agreement provided that if the corporation did not redeem the bonds at maturity it would pay interest at the rate of five per cent. None of the taxpayers had any interest in the corporation other than their investment in the bonds. They held the bonds until maturity, and the bonds were redeemed as they matured until 1957 when the parties agreed to postpone the redemption of a

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[2] This interpretation has also been recently followed by the Tax Court. See Richard B. Gibbons, 37 T.C. No. 57; David Leavin, 37 T.C. No. 73.

portion of the bonds maturing that year. The corporation amortized the original issue discount over the life of the bonds and deducted the amount allocated to each year as an interest expense.

The taxpayers hitch their wagon to a literalistic construction of the statutory term, "in exchange therefor". Under Section 1222 (3) (of the 1954 Code) a long-term capital gain is defined as the "gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income." To qualify as a capital gain income must be received not merely in an "exchange" but "in exchange for a capital asset."[3] The fact that a gain is received in an "exchange" is a prerequisite to capital gains treatment, but it does not by itself insure such treatment. When the right to receive ordinary income is sold, the proceeds from that exchange do not qualify for capital gains treatment. *Commissioner v. Lake*, 1958, 356 U.S. 260, 78 S. Ct. 691, 2 L. Ed. 2d 743. The weight of the taxpayers' argument therefore, rests on the word "therefor" rather than on the words "in exchange"—they would maintain that the statute requires all the proceeds from the retirement of a

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[3] "The definition of 'capital asset' is considerably broader than is justified by the rationale for capital gains and if read literally would encompass income which Congress did not intend to give the benefit of the lower capital gains tax rate. Consequently, the courts have narrowly interpreted the definition of capital assets. See, e.g., Corn Products Refining Co. v. Commissioner, 350 U. S. 46, 52, 53-54 (1955); Commissioner v. P. G. Lake, Inc., 356 U. S. 260, 265 (1958). A distinction has arisen between an income-producing capital asset and the income which it produces. Gains arising from the sale of such an asset which has appreciated in value are capital gains, but gains flowing from the sale of an accrued right to collect the income from such an asset are not. Thus the right to collect ordinary income is not transmuted into capital gain by its sale. See, e.g., Hort v. Commissioner, 313, U. S. 28, 31 (1941); Commissioner v. P. G. Lake, supra, at 266. If both the income producing asset and the right to accrued income from the asset are sold together, the purchase price must be allocated between the two, only the former being a capital asset." Jaglom v. Commissioner, 2 Cir., June 4, 1962, F. 2d.

bond to be treated as received in exchange *for the bond* which is a capital asset. This would conflict with the well established and soundly reasoned rule that when property is sold any portion of the proceeds that represents a right to receive ordinary income is taxed as such, even though the principal asset transferred is a capital asset. *Commissioner v. Phillips*, 4 Cir., 1960 275 F. 2d 33; *Tunnell v. United States*, 3 Cir., 1958, 259 F. 2d 916.

As pointed out in the Morgan and Rosen opinions, Section 117 (f) was enacted in response to *Watson v. Commissioner*, 1932, 27 B.T.A. 463. Watson held that since the capital gains provisions were tied to the term "sale or exchange", a bond retirement could not qualify. The ruling blocked capital gains treatment in cases where by the underlying tests it would be appropriate; for example, the gain received when a bond purchased at a depressed market price is redeemed at par. The gain realized from such a transaction is a form of capital appreciation that resembles the capital gain received when stock or real estate is purchased and later sold at a profit, in contrast to an original issue discount gain which represents the interest or compensation paid for the use of the money loaned. In the light of its historical setting and pertinent tax principles, the natural reading of "in exchange therefor" is to permit capital gains treatment, not compel it. It is implausible that Congress intended by use of this language to discard other tests that regularly must be met before a gain qualifies for capital gains treatment under Section 1222 (3). As we read Sections 117 (f) and 1232 (a), the critical words are "in exchange". "Therefor" is a filler word necessary to complete the grammatical structure of the sentence. We cannot believe that Congress intended to give "therefor" the drastic effect contended for by the appellants. Had it wished to achieve that result it doubtless would have provided expressly for capital gains treatment. The structure of the

provision as it stands indicates a purpose to liken a bond retirement to a sale or exchange and subject it to the same tax treatment that a sale or exchange would entail. The reasons pointing to this conclusion are more fully discussed in the Morgan and Rosen decisions. We believe that their reasoning is sound, and we follow their lead. The proceeds in question in this litigation represent regular income and should be taxed as such.

The judgment is

REVERSED.

BROWN, Circuit Judge, concurring specially:

I concur but not without some misgivings. I would emphasize that we are not here dealing with the status of proceeds received upon an ordinary commercial market sale of such bonds subsequent to the time of original issuance. From the interplay of economic laws which may even defy judge-made laws, the price will fluctuate, up and down, above or below the normal par (face) value depending on the supply of money, the demand for it, and other economic factors. See *The Hanover Bank, Executor v. Commissioner*, 1962, — U. S. —, S. Ct. —, — L. Ed. 2d — [May 21, 1962, 30 L. W. 4385].

This pinpoints the difficulty with any broad statements such as the Court makes about a "well established and soundly reasoned rule that when property is sold and a portion of the proceeds that represents a right to receive ordinary income is taxed as such, even though the principal asset transferred is a capital asset. *Commissioner v. Phillips*, 4 Cir., 1960, 275 F. 2d 33; *Tunnell v. United States*, 3 Cir., 1958, 259 F. 2d 916." Conceptually at least this is an-

other one at odds with our consistent statement recently reiterated in *Sherlock v. Commissioner*, 5 Cir., 1961, 294 F. 2d 863, that this Court, in contrast to some others, follows the aggregate, not the entity, theory so that taxability is not to depend on chopping up into little bits something which is whole and sold (or exchanged) as a whole.

At what stage does the original-issue-discount cease to have the operative effect of additional interest for the use of money? Does a portion of it, somehow like some marine life incrust itself permanently as a barnacle on the bond? When the original-issue-holder No. 1 sells, he sells all. As between him and his vendee (Holder No. 2), would it not (except for current accrued interest) all be capital gains just as would be the sale of an ordinary promissory note? Certainly as to the next transaction — the sale between Holder No. 2 and Holder No. 3 — all Holder No. 2 can ever hope to get is the face of the bond (and interest accruing during his ownership). If Holder No. 2 can treat it as a capital gain on a sale to Holder No. 3, why is it so implausable (as the Court says) that Congress could have intended that Holder No. 1 may treat it the same way on the redemption as he would have on a sale to No. 2 at which time he gets the same, no more, no less. The effort to look at the "real" or "original" nature of the gain, i.e., the difference, leads to metaphysical dialectic when one considers successive transactions in which, say between the time Holder No. 4 acquires it and Holder No. 7 sells it (at par), the market price at which No. 6 bought it was at the level of the face value less original issue discount. What changes the character of the very same number of dollars arising out of the very same contract? Indeed, as I read it, the Court in effect says the answer should be the same. "The structure of the provision as it stands indicates a purpose to liken a bond retirement to a sale or exchange and sub-

ject it to the same tax treatment that a sale or exchange would entail."

These seemingly internal contradictions and the problems I have just barely sketched cause me to have these considerable misgivings whether our effort to make sense really makes much.

UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

OCTOBER TERM, 1962

No. 19,059

D. C. Docket Nos. 7340, 7347, 7366

UNITED STATES OF AMERICA,

Appellant,

versus

O. D. HARRISON and wife JENNIE L. HARRISON; ADDISON O. WOOD and wife JOANNA G. WOOD; and EDWARD H. JACKSON and wife MARGARET J. JACKSON

Appellees.

Appeal from the United States District Court for the Western District of Louisiana.

Before Rives, Brown and Wisdom, Circuit Judges.

J U D G M E N T

This cause came on to be heard on the transcript of the record from the United States District Court for

the Western District of Louisiana, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed.

"Brown, Circuit Judge, Concurs Specially"

June 22, 1962

Issued:

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 19,059

UNITED STATES OF AMERICA,

Appellant,

versus

O. D. HARRISON and wife JENNIE L. HARRISON; ADDISON O. WOOD and wife JOANNA G. WOOD; and EDWARD H. JACKSON and wife MARGARET J. JACKSON

Appellees.

Appeal from the United States District Court for the Western District of Louisiana.

(September 27, 1962)

ON PETITION FOR REHEARING

Before RIVES, BROWN, and WISDOM, Circuit Judges.

PER CURIAM:

It is ORDERED that the petition for rehearing filed in the above styled and numbered cause be, and the same is hereby

DENIED.

IN THE

UNITED STATES DISTRICT COURT FOR THE

WESTERN DISTRICT OF LOUISIANA

SHREVEPORT, DIVISION

CIVIL ACTION NO. 7340
ADDISON O. WOOD AND WIFE
JOANNA G. WOOD
VS.
UNITED STATES OF AMERICA

CIVIL ACTION NO. 7347
EDWARD H. JACKSON AND WIFE
MARGARET J. JACKSON
VS.
UNITED STATES OF AMERICA

CIVIL ACTION NO. 7366
O. D. HARRISON AND WIFE
JENNIE L. HARRISON
VS.
UNITED STATES OF AMERICA

HUNTER, JUDGE:

These actions were instituted by the taxpayers for the recovery of income taxes and interest assessed and collected for the calendar years 1953 through 1957 in the total sum of $11,222.23. On taxpayers' motion these cases were consolidated for trial before the Court.

QUESTION PRESENTED

Whether the original issue discount on second mortgage bonds of the Washington-Youree Hotel Company, Inc., when realized by the taxpayers at retirement, constituted interest taxable at ordinary income rates within the meaning of Section 22 (a) of the Internal Revenue Code of 1939 and Section 61 (a) (4) of the Internal Revenue Code of 1954, or, whether it constitued "amounts received * * * at retirement" within the meaning of Section 117 (f) of the Internal Revenue Code of 1939 and Section 1232 (a) of the Internal Revenue Code of 1954.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) [as amended by Section 1 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574] *General Definition.* — "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income de-

rived from any source whatever. * * * (26 U.S.C. 1952 ed., Sec. 22).

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SEC. 117. CAPITAL GAINS AND LOSSES.

* * *

(f) *Retirement of Bonds, etc.*—For the purposes of this chapter, *amounts received by the holder upon the retirement of bonds*, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, *shall be considered as amounts received in exchange therefor.* (Emphasis ours) (26 U.S.C. 1952 ed., Sec. 117.)

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.* — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

(4) Interest; * * * (26 U.S.C. 1958 ed., Sec. 61)

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness, which are capital assets in the hands of the tax-

payer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.* — Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954). * * * (26 U.S.C. 1958 ed., Sec. 1232)

THE FACTS

The facts in this case are not in dispute and have been completely stipulated. In 1952 petitioners purchased $404,850 of second mortgage bonds of the Washington-Youree Hotel Company, Inc. for $300,000. They held the bonds until they matured (at various times during 1953-1957) and were retired by the Washington-Youree Hotel Company, Inc. at their face value. It is clear that the difference between the face amount of the bonds and their selling price was computed on the basis of a bonus for their purchase in the amount of $50,000, with interest upon cash and bonus at the rate of 3-3/4th per cent per annum. Petitioners claimed the gain they had realized upon retirement of the bonds was taxable as long-term capital gain because the amount had been received in exchange of the bonds under Section 117(f) of the Internal Revenue Code of 1939 and Section 1232(a) of the Internal Revenue Code of 1954. The Commissioner of Internal Revenue denied the amounts received from the bonds constituted the amounts received upon retirement of a bond and assessed tax at ordinary income rates upon

the gain. The assessment was paid, a claim for refund was filed by petitioners and rejected by defendant, and petitioners instituted this suit.

Relying on *Morgan*,[1] the Government insists that the difference between the purchase price to the taxpayers and the maturity value plainly constituted compensation for the use of the taxpayers' money, and thus this difference is taxable as ordinary interest. Petitioners, relying on Caulkins,[2] argue that they are entitled to treat the amounts which they received in retirement of the bonds as amounts received in exchange for them under Sections 117(f) and 1232(a) of the Codes of 1939 and 1954, and accordingly, that the gain is taxable as a long-term capital gain.

THE LAW

Two forums have passed on this exact problem. The Sixth Circuit Court of Appeals decided the Caulkins case, supra, and adopted the taxpayers' theory. Last year, the Court of Appeals for the Ninth Circuit handed down its opinion in Commissioner v. Morgan, supra, which adopted the Government's position. The two decisions are irreconcilable and this Court is faced with the task of choosing the one which it feels better effectuates the scheme of taxation as framed by the Congress.

We believe that much can be said for the Government's description of the taxpayers' position as a tedious one that interest under the facts (Stipulation, Paragraph 3) is not interest under the law (Sec. 117(f)), but we must apply the statute as we find it, leaving to Congress

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[1] *Commissioner v. Morgan*, 272 F. 2d 936, 9 C.C.A. 1959.

[2] *Commissioner of Internal Revenue v. Caulkins*, 144 F. 2d 482, 6 C.C.A. 1944.

the correction of asserted inconsistencies. Perhaps it would be well to add here that in the 1954 Code, Congress included a provision to correct and clarify the precise problem now presented. The 1954 Code includes a provision relating to original issue discount bonds issued after December 31, 1954, which expressly makes such gain realized by the holder subject to ordinary income rates (Internal Revenue Code of 1954, Sec. 1232(a) (2)). The new law clearly and concisely separates the interest element (which we admittedly have here) from the capital gain element. But, lest it be argued that this effected a change in prior law, we quote the Senate Committee's comment relative to this new section:

"S. Rep. No. 1622, 83d Cong., 2d Sess., p. 112 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4745):

> "Under Section 117(f) of the present law, when a corporate or Government bond in registered form or with coupons attached is retired the transaction is treated as a sale or exchange. There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount (see I.T. 3486, 1941-2, C. B. p. 76, as compared with *Comm. v. Caulkins*, 144 F. 2d 482). In these cases, that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.
>
> "Effective with respect to bonds issued after December 31, 1954, the House bill re-

> moves doubt in this area by providing that any sale realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income. This is, of course, not intended to have any effect with respect to bonds issued before that date.
>
> "Thus, the Congress chose to leave to the courts settlement of the question as to evidences of indebtedness issued before January 1, 1955."

We agree with Caulkins and it is completely consistent with the jurisprudence of the Section which, except for *Morgan*, has uniformly accorded capital gain treatment to the retirement of bonds under Section 117(f), *Reiger v. C.I.R.*, 139 F. 2d 618 (1943); *Timkin v. C.I.R.*, 6 T.C. 483 (1946), Acq. noted 1946-2 C.B. 5; *Howard C. Avery*, 13 T.C. 351 (1949), acq. noted 1950-1 C.B. 1; *Adolph Klein*, 15 T.C. 26 (1950), acq. noted 1950-2 C.B. 3; *Steven W. Kormendy*, 18 T.C.M. 353 (1959); and *Eli D. Goodstein*, 30 T.C. 1178 (1958), affirmed 267 F. 2d 127 (1959).[3]

There is absolutely no warrant for the conclusion that in enacting Section 117(f) Congress intended anything other than what is clearly said—that the retirement of a bond is equivalent to its exchange; that any amount received in excess of its cost would be capital gain; and that upon receipt of less than its cost a capital loss will ensue. Whether it should or should not have done this, or whether Congress made a mistake which they have now rectified, is a matter over which this Court has no control. Certainly, there is nothing in the

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[3]Appeal by taxpayer on other points. The Court of Appeal did not pass upon the point in question; perhaps the Commissioner did not urge it.

legislative history of the Act to indicate that the congressional intention was to limit Section 117(f) to losses, and it would be surprising if Congress defined a loss from a transaction as a capital loss and then were to treat a gain therefrom as an ordinary gain.

The whole matter involved in this law suit, including the jurisprudence, legislative history, and administrative interpretation of Section 117(f) of the Internal Revenue Code of 1939 and Section 1232(a) of the Internal Revenue Code of 1954 has been completely analyzed in an article by Harry Janin, found in 33 Taxes 191, March 1955, "*The Israeli Bond Ruling; Legislation by Fiat.*"

Judgment for plaintiffs. Counsel will present to the Court a formal judgment and this decision is not to be effective until the signing of that formal judgment.

THUS DONE AND SIGNED in Chambers at Lake Charles, Louisiana on this the 12th day of November, 1960.

E. F. N., JR.
UNITED STATES DISTRICT JUDGE

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	4
Argument	5
Conclusion	10
Appendix	11

CITATIONS

Cases:

Caulkins v. *Commissioner*, 1 T.C. 656	8
Commissioner v. *Caulkins*, 144 F. 2d 482	5, 7, 8, 9, 10
Commissioner v. *Morgan*, 272 F. 2d 936	5, 7, 8
Commissioner v. *P. G. Lake, Inc.*, 356 U.S. 260	6, 8
Commissioner v. *Phillips*, 275 F. 2d 33	6
Deputy v. *du Pont*, 308 U.S. 488	5
First Kentucky Co. v. *Gray*, decided November 21, 1962, 10 A.F.T.R. 2d 5984	6, 9
Fisher v. *Commissioner*, 209 F. 2d 513, certiorari denied, 347 U.S. 1014	6, 9
Gibbons v. *Commissioner*, 37 T.C. 569	8
Hort v. *Commissioner*, 313 U.S. 28	6, 8
Jaglom v. *Commissioner*, 303 F. 2d 847	6, 8
Lurie v. *Commissioner*, 156 F. 2d 436	7
Morgan v. *Commissioner*, 30 T.C. 881	8
Pattiz v. *United States*, decided January 11, 1963	8
Rieger v. *Commissioner*, 139 F. 2d 618	7
Rosen v. *United States*, 288 F. 2d 658	5, 8
Shafer v. *United States*, decided January 11, 1963 (C.A. 6th), affirming 204 F. Supp. 473	9
Tunnell v. *United States*, 259 F. 2d 916	6
United States v. *Langston*, 308 F. 2d 729	6

Cases—Continued Page

United States v. *Snow*, 223 F. 2d 103, certiorari denied, 350 U.S. 831 6
Valley Morris Plan v. *Commissioner*, No. 447, October Term, 1962, certiorari denied, 371 U.S. 922 10
Watson v. *Commissioner*, 27 B.T.A. 463 7

Statutes:

Internal Revenue Code of 1939, Sec. 117(f) (26 U.S.C., 1952 ed., Sec. 117(f)) 2, 6, 7
Internal Revenue Code of 1954, Sec. 1232(a) (26 U.S.C., 1958 ed., Sec. 1232(a)) 3, 6, 9
Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 117 7

Miscellaneous:

Hearings on H.R. 7835, Senate Finance Committee, 73d Cong., 2d Sess. 7
S. Rep. No. 1622, 83d Cong., 2d Sess. 9

In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 681

O. D. HARRISON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (R. 66-73; Pet. App. 12-19) is not officially reported. The opinion of the court of appeals (Pet. App. 1-8) is reported at 304 F. 2d 835.

JURISDICTION

The judgment of the court of appeals was entered on June 22, 1962 (Pet. App. 9-10). A petition for

rehearing was denied on September 27, 1962 (Pet. App. 11). The petition for a writ of certiorari was filed on December 21, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

In 1952, the taxpayers purchased from the issuing company second mortgage bonds with a face value of $404,850, maturing over the next five years. They paid $300,000, leaving an original issue discount of $104,850. At maturity, the company redeemed the bonds by paying taxpayers the face amounts.

The question presented is whether, under Section 117(f) of the Internal Revenue Code of 1939 and Section 1232(a) of the 1954 Code, that portion of the redemption payments representing the original issue discount is taxable as ordinary income, as the court below held, or as capital gain.

STATUTES INVOLVED

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * *

(f) *Retirement of Bonds, Etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.*—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or exchange.*—

(A) *General rule.*—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) an amount equal to the original issue discount (as defined in subsection (b)), * * *

* * * * *

shall be considered as gain from the sale or exchange of property which is

not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

* * * * *

STATEMENT

The relevant facts were admitted (R. 35-39) and stipulated (R. 61-64, 87-119) and may be summarized as follows (see Pet. App. 3-4, 15-16):

In 1952, taxpayers, three married couples, purchased from Washington-Youree Hotel Company, Inc., second mortgage bonds of that corporation with a face value of $404,850, which were due to mature in series over the next five years. They paid $300,000, leaving an original issue discount of $104,850, or 25.9 per cent of the face value. The bonds on their face (R. 36, 58) provided that if the corporation did not redeem the bonds at maturity it would pay interest thereafter at the rate of 5 per cent. The taxpayers had no interest in the corporation other than their investment in the bonds. They held the bonds until maturity and the bonds were redeemed as they matured until 1957 when the parties agreed to postpone the redemption of a portion of the bonds maturing that year. The corporation amortized the original issue discount over the life of the bonds and deducted the amount allocated to each year as an interest expense.

On their returns for each of the years in question (1953-1957), taxpayers treated as capital gain the excess of the amounts received upon redemption (face

value) over the cost of the bonds (74.1% of face) (R. 4, 9, 14). This treatment was disallowed by the Commissioner (R. 4, 9, 14), and upon payment of the resulting deficiencies, taxpayers filed suits for refund. The actions were consolidated and the district court upheld the taxpayers (R. 66-73). The court of appeals reversed, Judge Brown concurring (Pet. App. 1-6, 6-8).

ARGUMENT

1. The decision below is correct. The taxpayers' contention that the difference between the amount they loaned on corporate mortgage bonds and the amount they received upon retirement of the bonds must be treated as capital gain is directly contrary to fundamental principles of tax law and is not required by the pertinent statutory provisions.

It is settled that the difference between the amount loaned on corporate bonds and the amount received upon the retirement of those bonds, often referred to as the "original issue discount", is a form of interest or compensation for the use of the money. *Commissioner* v. *Morgan*, 272 F. 2d 936, 938 (C.A. 9); *Rosen* v. *United States*, 288 F. 2d 658, 660 (C.A. 3); *Commissioner* v. *Caulkins*, 144 F. 2d 482, 484 (C.A. 6). There is further no question that interest is taxable as ordinary income. *Deputy* v. *duPont*, 308 U.S. 488. It is also a well settled rule that ordinary income, including interest, retains its character as such whether received by itself or as part of the consideration for

the sale or exchange of a capital asset. *E.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Hort* v. *Commissioner*, 313 U.S. 28; *Commissioner* v. *Phillips*, 275 F. 2d 33 (C.A. 4); *Tunnell* v. *United States*, 259 F. 2d 916 (C.A. 3); *United States* v. *Snow*, 223 F. 2d 103 (C.A. 9), certiorari denied, 350 U.S. 831. Thus, if the bonds in this case had been sold or exchanged by the taxpayers at any time, the amounts received which represented the excess of the face value of the bonds over their original purchase price (the amount loaned) would unquestionably have been taxed as ordinary income, not capital gain. See *Jaglom* v. *Commissioner*, 303 F. 2d 847 (C.A. 2); *First Kentucky Co.* v. *Gray* (C.A. 6), decided November 21, 1962 (10 A.F.T.R. 2d 5984); *United States* v. *Langston*, 308 F. 2d 729 (C.A. 5); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6), certiorari denied, 347 U.S. 1014.[1]

In arguing that the original issue discount must be treated as capital gain, taxpayers rely on Sections 117(f) of the 1939 Code and 1232(a)(1) of the 1954 Code (*supra*, pp. 2-3) which provide that "amounts received * * * upon the retirement of bonds * * * shall be considered as amounts received in exchange therefor." Neither the language nor the legislative history of the statutes supports the contention.

Section 117(f) was enacted in 1934 for the

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[1] The *Jaglom*, *First Kentucky*, *Langston* and *Fisher* decisions hold that upon the sale of bonds purchased flat (*i.e.*, without allocation of purchase price between principal and interest), the vendor realizes ordinary income to the extent that the sales price is allocable to interest accrued on the bonds subsequent to their acquisition by the vendor.

purpose of reversing *Watson* v. *Commissioner*, 27 B.T.A. 463,[2] where the Board held that a redemption was not a sale or exchange and therefore that the capital loss provisions of the Code did not apply to such payments.[3] The purpose of Section 117(f) was to assure that payments made upon the redemption of a corporate bond would receive the same tax treatment as amounts received upon a sale or exchange of the bond. Nowhere in the text of the statute or in its legislative history is there any suggestion that it was meant to change the rules by which capital gain is distinguished from ordinary income upon a sale or exchange. See, *e.g.*, *Commissioner* v. *Morgan*, 272 F. 2d 936, 938 (C.A. 9).

2. While the decision below is in conflict with an early decision of the Sixth Circuit, *Commissioner* v. *Caulkins*, 144 F. 2d 482 (1944),[4] we do not believe that review by this Court is warranted to resolve the

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[2] The legislative history of Section 117(f) is set forth in *Commissioner* v. *Morgan*, 272 F. 2d 936, 938-939 (C.A. 9). See particularly Hearings on H.R. 7835, Senate Finance Committee, 73d Cong. 2d Sess. at 76.

[3] Section 101(c) of the 1928 Act defined capital gains and losses as the gains or losses resulting from a "sale or exchange" of capital assets.

[4] In *Rieger* v. *Commissioner*, 139 F. 2d 618 (C.A. 6) and *Lurie* v. *Commissioner*, 156 F. 2d 436 (C.A. 9), cited by taxpayers (Pet. 10, 23) as conforming to the *Caulkins* view, taxpayers' profit on retirement of the obligations merely reflected an upward fluctuation in their market value. No element of ordinary income was involved. In each case, the question for decision, wholly unrelated to the issue presented here, was whether the evidence of indebtedness was in "registered form".

conflict. In *Caulkins* the Sixth Circuit recognized that the portion of the redemption payment representing the original issue discount "is consideration paid for the use of the amounts paid in * * *" and that it was "difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income" (144 F. 2d at 484). However, it held that the words of Section 117(f) required capital gains treatment for all gain realized upon the redemption of a corporate bond and rejected the Commissioner's contention that the section "was not intended to cover the gain from interest, but only capital gain" (*ibid.*).

Every court of appeals which has considered the question since *Caulkins* has reached a contrary conclusion, *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3); *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Jaglom* v. *Commissioner*, 303 F. 2d 847 (C.A. 2) (expressly approving *Rosen* and *Morgan*), as has the Court of Claims, *Pattiz* v. *United States* (No. 219-61, decided January 11, 1963).[5] The Tax Court in *Gibbons* v. *Commissioner*, 37 T.C. 569, has also accepted the *Rosen* and *Morgan* position, expressly abandoning its prior view (*Caulkins v. Commissioner*, 1 T.C. 656; *Morgan* v. *Commissioner*, 30 T.C. 881). As indicated above, the soundness of the reasoning upon which the decisions of these courts rest is manifest. Moreover, *Caulkins* was decided before this Court's decisions in *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260 and *Hort* v. *Commissioner*, 313 U.S. 28, and the firm establish-

[5] For the convenience of the Court, the *Pattiz* opinion, recently issued, is reprinted as an appendix to this brief.

ment of the principle that ordinary income is not transmuted into capital gain through the sale or assignment of the capital asset which produces it together with the rights to the ordinary income. The widespread acceptance of this principle, even by the Sixth Circuit in other contexts (*Fisher* v. *Commissioner*, 209 F. 2d 513, certiorari denied, 347 U. S. 1014; *First Kentucky Co.* v. *Gray*, decided November 21, 1962 (10 A.F.T.R. 2d 5984); *Shafer* v. *United States*, decided January 11, 1963, affirming 204 F. Supp. 473 (S.D. Ohio)), suggests that if the issue in *Caulkins* were presented to the Sixth Circuit today, that court might well abandon its prior position and follow the rule now accepted in the other four circuits which have considered the question and in the Court of Claims and the Tax Court.

3. Moreover, the question here in dispute is of rapidly diminishing importance, for Section 1232(a)(2) of the 1954 Code (*supra*, pp. 3-4) expressly provides that as to bonds issued after December 31, 1954, any gain realized by a bond holder attributable to original issue discount is taxable as ordinary income.[8]

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[8] The taxpayers' reliance upon this change as indicating that the opposite rule was intended under the 1939 Code is mistaken. The Senate Committee Report stated (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 112):

> Under Section 117(f) of present law, when a corporate or Government bond in registered form or with coupons attached is retired the transaction is treated as a sale or exchange. There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount (see

Compare *Valley Morris Plan* v. *Commissioner*, No. 447, October Term 1962, certiorari denied, 371 U. S. 922.

CONCLUSION

For the foregoing reasons, we respectfully submit that the petition for a writ of certiorari should be denied.

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JOSEPH KOVNER,
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Attorneys.

FEBRUARY 1963

I.T. 3486, 1941-2 C.B. p. 76, as compared with *Comm.* v. *Caulkins*, 144 F. 2d 482). In these cases, that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.

Effective with respect to bonds issued after December 31, 1954, the House bill removes doubt in this area by providing that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income. This is, of course, not intended to have any effect with respect to bonds before that date. * * *

APPENDIX

IN THE UNITED STATES COURT OF CLAIMS

(Decided January 11, 1963)

No. 219-61

OSCAR S. AND LEONA W. PATTIZ v. UNITED STATES OF AMERICA

No. 244-61

ALEX DEUTSCH AND ELEANOR DEUTSCH v. UNITED STATES OF AMERICA

No. 245-61

LESTER DEUTSCH AND BETTY DEUTSCH v. UNITED STATES OF AMERICA

No. 282-61

ROSELLA FAMILIAN, AS TRUSTEE OF THE SONDRA J. FAMILIAN TRUST v. UNITED STATES OF AMERICA

No. 283-61

ROSELLA FAMILIAN, AS TRUSTEE OF THE GARY R. FAMILIAN TRUST v. UNITED STATES OF AMERICA

No. 284-61

ISADORE FAMILIAN AND SUNNY FAMILIAN v. UNITED STATES OF AMERICA

No. 285-61

ISADORE FAMILIAN, AS TRUSTEE OF THE ARNOLD FAMILIAN TRUST v. UNITED STATES OF AMERICA

No. 286-61

ROSELLA FAMILIAN, AS EXECUTRIX OF THE ESTATE OF GEORGE FAMILIAN, DECEASED, AND ROSELLA FAMILIAN, v. UNITED STATES OF AMERICA

No. 287-61

ANNETTE FAMILIAN SHAPIRO v. UNITED STATES OF AMERICA

Arthur B. Willis for plaintiffs. *John P. Lipscomb* was on the briefs.

Cynthia Holcomb, with whom was *Assistant Attorney General Louis F. Oberdorfer*, for defendant. *Edward S. Smith*, *Lyle M. Turner*, *Philip R. Miller*, and *George Willi* were on the briefs.

ON PLAINTIFFS' MOTIONS FOR SUMMARY JUDGMENT AND DEFENDANT'S MOTION FOR JUDGMENT ON THE PLEADINGS

WHITAKER, *Judge*, delivered the opinion of the court:

The issue presented in these cases is whether the difference between the purchase price of registered notes and the price at which the payor redeemed them is ordinary income or a capital gain.

Plaintiff's rely on section 117(f) of the Internal Revenue Code of 1939, as amended, which provides:

> For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidence of indebtednesses issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

In January or February of 1952 taxpayers purchased registered debentures issued by Winco #1, a California corporation engaged in "building and developing of buildings, tracts, and housing developments," at a price equal to two-thirds the debentures' face value. The debentures were all in the following form:

UNITED STATES OF AMERICA

State of California

No. ..... $ .....

Winco #1 Five Year Notes

Winco #1, a corporation organized and existing under and by virtue of the laws of the State of California (hereinafter called the Company), for value received, hereby promises to pay to the registered holder thereof ..... Dollars lawful money of the United States of Ameri-

ca, upon the 1st day of January, 1957, without interest.

The principal hereof is hereby made payable at the head office of Union Bank & Trust Co. of Los Angeles in the City of Los Angeles, County of Los Angeles, State of California.

This note is one of an issue of four hundred ten (410) Winco #1 Five Year Notes, duly authorized in the manner and form prescribed by law, the total principal amount thereof being Three Million ($3,000,000.00) Dollars, all of said notes being of like date, form and tenor, except the variations necessary to express their numbers and denominations * * *.

* * * *

The entire issue of said notes, or any part thereof, are subject to redemption by the Company at any time in the manner and upon the notice provided for in said Trust Indenture, upon the payment of the amounts hereinafter set forth for each One Thousand ($1,000.00) Dollars principal amount of the respective notes:

If such redemption shall occur on or before January 1, 1954, Eight Hundred Eighty Eight ($888.00) Dollars;

If such redemption shall occur thereafter and on or before January 1, 1955, Nine Hundred Twenty Two ($922.00) Dollars;

If such redemption shall occur thereafter and on or before January 1, 1956, Nine Hundred Fifty Five ($955.00) Dollars;

If such redemption shall occur thereafter, the full principal thereof.

The principal of this note and of all said notes may be declared due and payable prior to maturi-

ty in the manner and with the effect provided in said Trust Indenture in case default shall occur as therein provided.

This note shall be registered in the manner and upon the conditions and with the effect as set forth in said Trust Indenture.

This note shall not be valid or become obligatory for any purpose unless and until authenticated by the signature of Union Bank & Trust Co. of Los Angeles, or a successor trustee, upon the Trustee's certificate and registration endorsed thereon, and until authentication by the signature of the Company as to registration.

* * * *

Winco redeemed the debentures purchased by these taxpayers during 1953, paying $888 per $1,000 face value, as provided for in the debentures.

In each case, in their tax returns for the calendar year 1953, taxpayers reported the increment of the redemption price over their original purchase price and paid the capital gains tax thereon. In each case, the Commissioner of Internal Revenue determined that the gain on the redemption of the debentures constituted ordinary income, and assessed a deficiency. In each case the taxpayers paid the assessed deficiency and interest thereon and thereafter filed a claim for refund upon which each lawsuit is based.

The scope of section 117(f) has been before the Courts of Appeals in four different circuits. It first came before the Sixth Circuit in the case of *Commissioner* v. *Caulkins*, 144 F. 2d 482. Caulkins purchased in 1928 a so-called "Accumulative Installment Certificate" in the principal sum of $20,000, payable in ten years on condition that the required payments were made. Caulkins made the payments, which amounted

to $15,043.33, and at maturity was paid the sum of $20,000. The court held that the difference in the amount paid and the amount received was capital gain because of the provisions of section 117(f). Responding to the contention of the Commissioner of Internal Revenue that this was compensation for the use of money, held by the Supreme Court in *Deputy v. DuPont*, 308 U.S. 488, to be interest, the court said:

> Congress might well have made the differentiation urged by the Commissioner, *since it is difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income.* The fact that the contract does not provide for equal amounts of interest to be set aside each year, available to the holder, does not affect the question. *The increment is consideration paid for the use of the amounts paid in.* Unfortunately for the Commissioner's contention, Congress has not made the differentiation. [Italics ours.]
>
> * * * *
>
> * * * Clearly $20,000 was the amount received on the retirement of the certificate, and under the plain wording of § 117(f), it was taxable as a capital gain. A provision that the increment in such cases should be taxable under § 22(a) might or might not have been wise and fair; but Congress has not enacted it, and the courts cannot supply it by judicial legislation. Because of the application of the capital gains tax to securities which on their retirement may not result in capital gain, inconsistencies and inequalities may well result from the application of § 117(f). If this is so, the correction of this defect in the operation of the statute is for Congress and not for the courts. * * *

The Commissioner of Internal Revenue acquiesced in this decision from December 1944 to December 1954, when he withdrew his acquiescence.

Another one of these certificates came before the Ninth Circuit in the case of *Commissioner* v. *Morgan*, 272 F. 2d 936. That court refused to follow the *Caulkins* decision. It pointed out that, following the decision of the Supreme Court in *Fairbanks* v. *United States*, 306 U.S. 436, affirming a decision of the Ninth Circuit holding that the gain from the exchange of property for corporate bonds, which were retired by the corporation at par, was not a "sale or exchange of capital assets" and, thus, not a "capital gain", the Congress enacted § 117(f), only to make a retirement equivalent to a sale or exchange. However, it said that the section was not intended to cover the gain derived from the purchase of an original issue of bonds, or of other evidence of indebtedness, at a discount, because the difference between the purchase price and the agreed price at which the bonds were redeemed was compensation paid for the use of money, which was in all respects equivalent to interest, which was taxable as ordinary income under § 22(a), defining gross income. The Tax Court in *Watson* v. *Commissioner*, 27 B.T.A. 463, was in accord.

The Third Circuit came to the same conclusion in *Rosen* v. *United States*, 288 F. 2d 658. We regret we cannot quote extensively from this opinion since we agree with what was said in it.

The Fifth Circuit in *United States* v. *Harrison*, 304 F. 2d 835, 9 AFTR 2d 1848, came to the same conclusion. In that case the taxpayer purchased second mortgage bonds of a face value of $404,850 for $300,000. Among other things the court said:

> As pointed out in the Morgan and Rosen opinions, Section 117(f) was enacted in response to

> Watson v. Commissioner, 1932, 27 B.T.A. 463. Watson held that since the capital gains provisions were tied to the term "sale or exchange", a bond retirement could not qualify. The ruling blocked capital gains treatment in cases where by the underlying tests it would be appropriate; for example, the gain received when a bond purchased at a depressed market price is redeemed at par. The gain realized from such a transaction is a form of capital appreciation that resembles the capital gain received when stock or real estate is purchased and later sold at a profit, in contrast to an original issue discount gain which represents the interest or compensation paid for the use of the money loaned.

The *Harrison* and *Morgan* cases were cited with approval by the Second Circuit in *Jaglon* v. *Comm.*, 303 F. 2d 847, 9 AFTR 2d 1686.

We think this quotation correctly states the sort of gain Section 117(f) was intended to cover and the part it was not intended to cover. It was intended to cover gain derived from appreciation in value, or a case where the purchase was made from some one other than he who issued them at an advantageous price, but certainly not a case where an original issue of bonds or notes were sold at a discount, in lieu of payment of interest on them.

This is the case here. If these notes had been redeemed at their maturity date, the discount would have equalled interest at 10 percent, which is the legal rate in California, the State in which the corporation issuing the debentures was incorporated. For the privilege of redeeming them at an earlier date, the borrower agreed, when the debentures were issud, to pay a premium. We held in *Equitable Life Assur. Soc'y* v. *United States*, 149 Ct. Cl. 316, 181

F. Supp. 241, in an opinion written for the court by Mr. Justice Reed (Ret.), that prepayment charges were "an additional fee for the use of the lender's money for a shorter period of time than originally agreed upon," and that "[t]he charges are part of the compensation to the lender for the use of money." When the debentures were issued, the parties agreed upon the amount to be paid upon the retirement of them at certain stated times prior to maturity. This was the agreed compensation for the use of the purchasers' money for the prescribed periods.

In *Leaven* v. *Comm.*, 37 T.C. 766, the debentures were retired before maturity at a sum agreed upon when they were issued which was ratably higher than the sum payable at maturity. The Tax Court thought the amount agreed upon was compensation for the use of the purchaser's money for the specific period.

We think the discount at which these notes were sold was in lieu of the payment of interest on them, and that the difference in the amount paid for them and the amount at which they were redeemed was ordinary income. In our opinion it was not intended by § 117(f) of the Internal Revenue Code of 1939 to treat it as a capital gain.

The 1954 Code does not affect the transactions in this case. The 1954 Code effected a change in the law. It evidently was not intended as a clarification of Congress' intention when it enacted the Internal Revenue Code of 1939.

The plaintiffs' motions for summary judgment are denied, and the defendant's motions for judgment on the pleadings are granted. Plaintiffs' petitions are dismissed.

DAVIS, *Judge*; DURFEE, *Judge*; LARAMORE, *Judge*; and JONES, *Chief Judge*, concur.

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